CENTER FOR INSTITUTIONAL REFORM AND THE INFORMAL SECTOR

Universitv of Maryland at College Park

Center Office: IRIS Center, 2105 Morrill Hall, College Park, MD 20742
Telephone (301) 405-3110 • Fax (301) 405-3020

CONTRACTS IN BULGARIA: HOW FIRMS COPE WHEN PROPERTY RIGHTS ARE INCOMPLETE

June, 1995

Kenneth Koford and Jeffrey Miller

Working Paper No. 166

This publication was made possible through support provided by the US. Agency for International Development, under Cooperative Agreement No. DHR-0015-A-00-0031-00 to the Center on Institutional Reform and the Informal Sector (IRIS) and administered by the Office of Economic and Institutional Reform, Center for Economic Growth, Bureau for Global Programs, Field Support and Research.

Authors: Kenneth Koford and Jeffrey B. Miller, Department of Economics, University of Delaware, Newark, DE.

Contracts in Bulgaria:

How Firms Cope when Property Rights are Incomplete

Kenneth Koford

and

Jeffrey B. Miller

Department of Economics
University of Delaware
Newark, DE 19716

Comments welcomed.

This work was supported by the Center for Institutional Reform and the Informal Sector (IRIS) at the University of Maryland from a grant from the U.S. Agency for International Development under Cooperative Agreement No. DHR-0015-A-00-0031-00 which is administered by the Office of Economic and Institutional Reform, Center for Economic Growth, Bureau for Global Programs, Field Support and Research. Anastassia Miteva, Kamen Atannasov and Dimitrina Dirnitrova provided invaluable assistance in designing and conducting the survey as well as providing additional research assistance on the project. All remaining errors are the responsibility of the authors.

Revised June 1, 1995.

ABSTRACT

How are contracts among firms enforced in an economy in transition? Such economies are largely without a recent history of private property rights or of government enforcement of commercial contracts. We examine this question through a sample of Bulgarian firms, for which we conducted personal interviews. Firms were largely in the food processing and distribution industry, and included private, state-owned and cooperative firms.

All firms tried to work closely with trustworthy counterparts, and were very cautious about firms that might take advantage of them. Most firms had been "burned" by an excess of trust. We were surprised to find that even basically spot-market contracts had a considerable number of contractual problems. Failure to pay was very common, while failure to deliver and quality problems occurred with suppliers. Firms engaged in a surprising amount of litigation, although they did not expect lawsuits would be very effective. As a result, complex contracts were quite limited. In some cases, this led to the breakdown of important markets.

The study investigates the most fundamental institution of capitalism: the market. In a survey conducted 3 1/2 years after shock therapy was applied to the Bulgarian economy, firms were asked about their trading relations with other firms. We found a wide array of market arrangements. However, market participants were very concerned with whether they can expect their trading partners to fulfill agreements. This was true across types of firms and market arrangements. Many firms had early experiences with unreliable trading partners. Firms, therefore, develop their market relations cautiously. Except where longer-term relationships have developed, insist on up-front payments or forms of guaranteed payment which resemble letters of credit.

If the legal system protected firms against serious losses, market relationships might be less constrained. As the market economy evolves, the court system is also developing. Despite managers' perception that the legal system is clumsy and unresponsive, a surprisingly large number of firms have cases pending. A few even received awards through legal action. Still, economic agents largely rely on other methods to protect themselves from unreliable trading partners.

Evidence from the survey supports Calvo and Coricelli's (1993) view that a "trade implosion" may have been an important factor in causing the sharp output decline in Eastern Europe when the reforms were undertaken. They focus on the reduction in credit availability as a key factor in explaining the fall in output. Survey participants described a severe constraint on both trade credit and bank credit, due to information asymmetries.

Our survey evidence suggests that shock therapy can create an environment where many, but not all, economic agents will learn rapidly about how markets operate. Initially. costly institutional arrangements (that would be considered inefficient in a more stable world) are needed as agents try to protect themselves. Sometimes these transactions costs are so high, as in financial markets, that market failure results.

The questionnaire concentrated on the nature of trading relations between firms. The

study follows in the tradition of Coase (1960), Williamson (1975, 1985), and Klein, Crawford and Alchian (1978) in focusing on transactional relationships to understand how economic activity is being organized. Empirical studies which ask questions similar to ours have been carried out by Ellickson (1991), Macauley (1963), Sako (1992) and Paley (1984).

Following Macauley (1963) and Ellickson (1991), it was our expectation that there would be little litigation. The opposite was the case. Many firms we interviewed had gone to court or contemplated going to court. The courts are crowded with commercial cases and backlogs are long. Several firms were also suing in foreign courts, although success there appeared to be very limited.

There was a consensus among our interviewees, including some who were suing trading partners, that court action was unlikely to bring redress. Several managers said that they did not bother with the courts because they did not expect to be compensated. Since this is the general attitude, it is clear that managers do not depend on lawyers and courts to enforce their contracts. The evidence of firms' efforts to write self-enforcing contracts or to find trustworthy partners is evidence for this claim, which may be restricting firms' ability to develop.

Contracts in Bulgaria:

How Firms Cope when Property Rights are Incomplete

I. Introduction

The debate over the transition from central planning to capitalism is often stated in terms of the speed of adjustment. Such opponents of "shock therapy" as North (1990) and Murrell (1992) have argued that substantial institutional adjustments are required for successful change, This study investigates the institutional innovations required in the most fundamental institution of capitalism: the market itself. In a survey conducted three and one-half years after shock therapy was applied to the Bulgarian economy, firms were asked to describe their contractual dealings with trading partners.

Semi-structured interviews were conducted with thirty-six firms throughout Bulgaria. The interviews were concentrated in food processing and food distribution where there are a variety of ownership types: state-owned, private, cooperative and newly privatized.

Firms reported a wide array of market arrangements. Yet the greatest concern of market participants is whether they can expect their trading partners to fulfill agreements. This was true across types of firms and market arrangements. Most firms had early experiences in the market with unreliable trading partners. Firms, therefore, develop their market relations cautiously. Firms try to protect themselves by insisting on up-front payments or forms of guaranteed payment which resemble letters of credit, until longer-term relationships have developed.

If the legal system protected firms against serious losses, market relationships might be less constrained. The court system is also developing to protect contractual relations in the market. Despite firm managers' perception that the legal system is clumsy and unresponsive, a surprisingly large number of firms have cases pending. A few even received awards through legal action. Still, as long as the court system is costly and imperfect, economic agents will rely on other methods to protect themselves from unreliable trading partners.

Evidence from the survey supports Calvo and Coricelli's (1993) view that a "trade implosion" may have been an important factor in causing the sharp output decline in Eastern Europe when the reforms were undertaken. They focus on the reduction in credit availability as a key factor in explaining the fall in output and point out that of the five Eastern European countries studied Bulgaria had a particularly sharp credit contraction.[1] Survey participants described a severe constraint on both trade credit and bank credit, due to information asymmetries.

Our survey evidence suggests that shock therapy creates an environment where many, but not all, economic agents will learn rapidly about how markets operate. But shock therapy is also highly disruptive. Initially, costly institutional arrangements (that would be considered inefficient in a more stable world) are needed as agents try to protect themselves from unreliable business partners. Sometimes these transactions costs are so high, as in financial markets, that market failure results.

Outline of the Report

Since the actions of business firms are best understood in the context of general economic conditions, Section II provides a brief description of the economic situation in Bulgaria in June 1994 when the survey was conducted. This is followed by a more detailed description of the economic conditions in the agricultural sector.

[1] Calvo and Coricelli emphasize the tight credit policies in these countries. Yet undeveloped credit markets can create the same outcome. If lenders cannot evaluate risks because of information problems, they will not make loans even when money is available. See Tosovsky's (1993) comment on their article.

To make the transactional issues more precise, we focused our survey in one sector of the economy. This made firms' technology much less variable. Because we wanted to include firms with a variety of ownership types, we chose to concentrate on the food processing and distribution sector of the economy. Our survey includes state enterprises, private firms, cooperatives and privatized state enterprises. As the survey proceeded, some firms from outside this sector were included to see if OUT earlier observations could be generalized. Still, twenty-eight of the thirty-six interviews were conducted with firms in the food processing and distribution sector.

There are many special conditions which have affected the agricultural sector. The most important are land restitution with its impact on agricultural supplies, and price controls which have not been totally abandoned. In addition, food is a necessity, and many food products cannot be easily transported long distances. This results in greater demand stability in this sector than in the bulk of manufacturing.

Section III reviews the literature on contractual relations between firms. Section IV describes the survey procedures used in the study. Since the movement to a market economy requires significant adjustments in institutional arrangements, in Section V we briefly describe the situation before the reforms and the sorts of institutional changes might be expected. Section VI presents the survey results.

In conducting the interviews we often found that responses to more probing questions were the most revealing. This is consistent with Williamson's thesis that to understand the contractual relationships between firms the study must be "microanalytic." Since details of specific circumstances are important, it is difficult to summarize these results in statistical form. Appendix B provides more detailed descriptions of the individual interviews, while Appendix C includes a detailed set of answers to the questionnaire..

II. The Bulgarian Economy and the Development of the Legal System[2]

General Trends

The political revolution in Bulgaria took place in November 1989 with the peaceful overthrow of the Zhivkov regime. In February 1991 shock therapy was applied, as price controls were dropped on most goods and private trading activity was allowed. (Some prices of agricultural products were still controlled.) Because Bulgaria had insufficient reserves to maintain a fixed exchange rate, the lev was allowed to float. Bulgaria is a small country and much of its trade was with the former Soviet Union and the other countries of Eastern Europe. The economy was severely hurt when trade relations among these countries broke down. In addition the previous regime left Bulgaria with large debts owed to European banks.

Output declined in 1989; the decline accelerated in 1990 and 1991, and then slowed in 1992 and 1993. Overall the level of output declined approximately 30% over this period. The decline in state enterprise industrial production was even greater reaching about 50% of the 1988 production level at the end of 1993.[3] While a bottoming out of the downturn has been anticipated, as of June 1994 there was no clear evidence of a rebound. Nearly all the state enterprises in the survey reported output levels that were far below capacity levels.

After prices were released in February 1991 inflation was also high, exceeding 300% in 199 1. In 1992 consumer price inflation was approximately 80%. It declined to approximately 65% in 1993, but increased again in early 1994 with the implementation of a VAT tax in April

[2] For a more complete description of economic conditions in Bulgaria see World Bank (1993) and OECD (1992).

[3] These figures were taken from Bartholdy (1994).

and a sharp fall in the exchange rate value of the lev.

The high rates of inflation have forced nominal interest rates also to be high. Interest rates on bank credit have been in the range of 60 to 80% throughout the period. With these high nominal rates several managers in the survey have clearly learned about the relationship between time and money. Even for those enterprises which had access to credit, borrowing was seen as extremely costly. Trade credit advanced by others was considered very valuable, and inventory control was seen as a way to protect profits.

In the summer of 199 1, a few months after most prices had been freed, the lev/dollar exchange rate settled into the range of 16 to 17 lev to the dollar. At the beginning of 1992 the lev climbed into the low 20's. For the next 20 months the rate only increased into the mid-20's in spite of the very high consumer price inflation. In the late fall of 1993 and then again in spring of 1994 the lev depreciated dramatically on several occasions. During the interviews in June 1994 the lev was in the mid-50's. Under newly negotiated agreements the first large payments on the national debt were to be paid to European creditors. People expressed concern that the lev would move dramatically again when these payments were made.

Government revenues had fallen dramatically as the transition proceeded. To shore up the revenue base and follow European taxation standards, a value-added tax was passed in the fall of 1993 and put into effect in the spring of 1994. Several managers in the survey commented that the tax had an effect and forced then to increase their prices.

Privatization has proceeded very slowly in Bulgaria. Restitution was the first method of privatization. Many buildings, including houses, were returned to their original owners. Farmland and farm animals, equipment and buildings are also being restituted, but this process has been much slower than originally anticipated. Many Bulgarians owned their apartments before 1989.

Under pressure from the World Bank, a privatization act was passed in the spring of 1992. Under the act, the principal method of privatization was cash sale of enterprises by negotiation or auction. Relatively few enterprises had been privatized. The government finally passed amendments to the privatization act during June 1994 calling for mass privatization using vouchers. At the time of the interviews details of these new procedures had not been disseminated, although some of the business directors we interviewed expected that the mass privatization might affect them. The privatization plan was delayed further after the Berov government resigned and new elections were held in late 1994; the project is just getting under way in May 1995.

The Agricultural Sector

The movement towards a market economy has led to dramatic changes in the agricultural sector. The most significant movement has been the restitution of land. As part **of this** process, liquidation councils were created to distribute animals and equipment among agricultural workers.

The result of this process has been the breakdown of existing agricultural institutions and a groping towards new institutional arrangements. Many of the problems are related to the small size of the production units that have resulted from this process. It seemed clear to us that there was a need for these small units to join together for more cffrcicnt production. **The speed** of **land** restitution has also been a problem. For many reasons the process has been much slower than originally anticipated and has not been well coordinated with liquidation of animals and equipment. For example, farmers in some instances have obtained livestock before receiving grazing land. As a result, many animals have been slaughtered and herds are much smaller now. All the milk producers we interviewed described the difficulty of obtaining milk now that there are fewer cows.

Restitution has also lowered the level of knowledge of people working in agriculture. Much farmland has been returned to people who live in cities. Farmers are required to do different tasks than they did in the past, in particular those who now are independent farm owners. Several food processors we interviewed mentioned programs designed to provide technical assistance to inexperienced farmers. Also, all farm operations must now act as independent businesses rather than part of a huge state organization.

The slow process of restitution has caused other problems as well. There are three stages of proceedings. Special certificates give the claimant the right to work the land but not rent it or sell it. Ownership certificates allow the claimant to lease it, but not sell it. Titles give the right to sell. Fees to obtain title may exceed the value of the land. Without title to the land, however, it is **difficult** to use the land for collateral. In late 1993 only 805 titles covering 611 hectares had been granted (USDA, Economic Situation Report, 1993).

In addition to state farms, there were also farm cooperatives during the Communist period. Cooperatives existed in Bulgaria before the Communist period, but their situation changed under the Communists when they were more subject to state control. In addition to farming, these cooperatives were also involved in other activities such as food retailing. For example, bread stores in small villages were generally operated by cooperatives.

With the transition me cooperatives have changed. They are now independent of state control. In many ways they are operating as private labor-managed firms, making their own decisions and paying dividends to their members. In several instances we surveyed cooperatives that had chosen to split. The agricultural cooperative decided to operate separately from the retail distribution cooperative.

We also spoke with people in cities whose land had been restituted. In many instances the agricultural cooperatives had agreed to lease the land back from these people and continue to farm the land. Because historically many people had been forced to join cooperatives during the Communist period, there is bad feeling about the cooperatives. Some people refuse to join cooperatives today even though it means attempting to farm inefficiently small plots of restituted land.

While cooperatives operate farms, processing and distribution units, in other parts of the food sector there is a three tier ownership pattern developing. Land is being returned to private farming, but the slow privatization of state enterprises has left most food processing in state hands. The retail distribution and the exportation of food is now private. There are relatively few state-owned retail food stores now. Thus if one looks at the passage of food through the production-distribution system, there are private agricultural agents selling to state-owned food processing enterprises which are selling to private wholesale/retail companies.

An exception to this rule is in sectors where capital costs required to start a processing plant are small. Then entry of small firms occurs. The best example is baking. Many small private bakeries have opened and are now competing successfully with the large state bakeries. It was estimated by a specialist we interviewed that 65% of the bread is now produced in these small bakeries. Even here, however, the pattern of movement of food from private sector to state enterprise to private sector is still present since private bakeries must buy their flour from state cnterprises.

In most productive sectors entry of new firms is difficult because of the need for large amounts of capital. Without new entry, state firms are unresponsive to customers' needs. For example, we heard complaints about the forage industry. One firm determined that with improved quality of forage, profits could be improved by 10-14%. When it offered higher prices for higher quality, state-enterprise forage producers refused to respond. They would not even consider quality clauses in their contracts. Forced to buy forage within a constrained geographical region, the firm which needed higher quality forage was seeking funding to integrate backward into forage production despite an acknowledged excess capacity in the region to produce forage. This contrasts sharply with the state-owned bakeries which are now producing new varieties of bread to fight the competition coming from the new private bakeries.

In February 1991 food prices were freed except for trade margin restrictions on fourteen essential items. This list was reduced to seven (bread, poultry, pork, veal, yoghurt, milk, and white goat's cheese) in May 1992 (World Bank, 1993). We found evidence in our interviews that margin inspections do take place, and fines are levied.

The price controls create perverse incentives. Since they control the percentage mark-up after production is completed, they encourage traders to purchase more expensive items to trade. In addition the same constraints do not apply to production. Some traders have found it advantageous to carry out certain forms of production, such as bottling, where the controls do not apply. Given the increased competition from new private traders, it is not clear why these margin controls are useful at this point in the transition.

Despite a variety of controls aimed at keeping them low, agricultural prices have risen sharply. Dry conditions and the absence of good irrigation systems have caused serious declines in agricultural production. The changes in the organization of agricultural production described above have caused reduced production. The fall in the international real value of the lev has made the export of many agricultural products very profitable at traditional prices. To try to counter this, the government has imposed export controls on wheat and export taxes on meat and milk (World Bank, 1993). It has prohibited the export of live animals at several points, and placed controls on the export of white cheese.

Finally, as occurred in other sectors, many food producers lost customers from the collapse of traditional trade patterns in the East European trading block. Some of these relations are being slowly reestablished, but many food processors who exported in the past are producing well below capacity levels. Some are looking to markets in western Europe, but they face serious problems. For example, most fruit and vegetable processors have been producing canned products (i.e., packed in glass jars). But this is now the smallest segment of the west European market, after frozen, fresh and dried produce. While there should be a market for fresh Bulgarian produce in western Europe, border crossing can cause serious delays and make timely delivery difficult.[4]

Development of the Legal System

Along with changes in economic institutions, the legal system has been adjusting to the new environment. Of special interest to this study is how well the legal system supports the enforcement of contracts.[5]

Under socialism, distinctions were made between contracts where state enterprises interacted and contracts involving private parties. Civil codes governed practices in the private sector. Furthermore, contracts were subordinated to the needs of the central plan. Most Eastern

[4] Cloy Hamilton, a USDA representative in Sofia, suggested that air-transport is an expensive alternative that nevertheless might solve this problem.

[5] The importance of contract enforcement is illustrated by Freeman (1991). He shows that multiple equilibria are possible in contract enforcement. The essence of the two equilibria is that if most agents fulfill contracts, it is worthwhile to punish those who do not. But if most agents do not fulfill contracts, it is not worthwhile to punish violators. If the government had sufficient "agenda control" power, it might be able to move the economy from the bad to the good equilibrium, but this requires considerable credibility in the decision of the government to help enforce contracts.

European countries have expanded the use of the existing Civil code and central planning is no longer important. In Bulgaria the Law on Obligations and Contracts of 1950 (amended in 1993) which governed private activity is still the basis of the civil code. Grey (1993, p. 36) notes that "[t]his law reflects generally-accepted civil law concepts of contract and thus has provided an acceptable legal framework for private sector activity."

An important element missing from this law is the concept of bankruptcy. When the interviews were carried out in June 1994, a new bankruptcy law was being considered by the Parliament. This law was later passed. International lending agencies were putting heavy pressure on the Bulgarian government to pass a bankruptcy law (and mass privatization amendments to the Privatization Act of 1992). Before the new bankruptcy law was passed, the prevailing procedures were defined under Decree 56. Decree 56 was passed in 1989 before the overthrow of the Zhivkov regime. It reflected an environment where the state was expected to bail out state enterprises. The Decree makes it difficult for creditors to begin bankruptcy proceedings (Gray, 1993).[6] However, it is possible to go to court to collect payments and seize assets.

However, civil courts are clearly available to carry out the relatively straightforward tasks of assuring adherence to payment terms. This is the issue of greatest concern to most firms we interviewed. The courts had difficulties when the number of commercial cases soared after 1991;

---

[6] Note this is in sharp contrast with the Hungarian situation where a forceful bankruptcy act is playing an important role in the restructuring of the economy.

The absence of a bankruptcy law does not mean that all state enterprises are remaining open. As one businessperson told us, when enterprises can no longer pay their bills, water and electricity are eventually shut off. Workers who are not paid leave. The plant can no longer function. The director sits in his darkened office, and the remaining security officer (paid by the police department) is left standing at the gate.

lawyers we interviewed claimed that these problems had diminished, but our business interviewees were skeptical about the efficiency and speed of the court system.

In addition to the development of the courts, the Chamber of Commerce has been instrumental in establishing arbitration procedures. International arbitration agreements employing international conventions are being used in Bulgaria. Arbitration procedures can be used to settle disputes between Bulgarian and foreign firms and between Bulgarian firms. The decisions reached by arbitration can be binding and enforced by the courts.

At present there are large backlogs in the courts, and the judges have limited experience in commercial cases. On the other hand, the arbitration courts are underutilized.

III. Literature Review

The questionnaire concentrated on the nature of trading relations between firms. As such, the study follows in the tradition of Coase (1960), Williamson (1975, 1985), and Klein, Crawford and Alchian (1978) in focusing on transactional relationships to understand how economic activity is being organized. Empirical studies which ask questions similar to ours have been carried out by Ellickson (1991), Macauley (1963). Sako (1992) and Paley (1984). We would also like to note important historical studies by Lamoreaux (1991, 1994). Other studies worth noting include Hackett (1994), Wiggins (1990), Clague (1991), Freeman (1991). Rubin (1993), Casson (1991), Smith and Schnucker (1994), and Tourevski and Morgan (1993).[7]

[7] Wiggins (1990) develops a model of incomplete contracting, showing how when firms are small, contracting can be more efficient. In contrast, large firms have some more difficult incentive problems, as it is difficult to assure proper incentives (based on bonuses) since these incentives can always be changed. The essence of the problem, Wiggins shows, is the timing of the different parts of the deal. Ownership of an asset is a credible commitment for carrying out an action, producing a product that will be examined and sold only after production.

Williamson is concerned with how transactions costs will influence institutional arrangements. He argues that in a market economy institutional innovations will occur which will reduce transactions costs. Since the institutionai arrangements under central planning were very different from the institutions needed for a market system, great changes should be anticipated once market forces are allowed to operate.

Williamson separates governance mechanisms for transactions into three kinds. In the first there is little dependence between the transacting parties. Competition is an important mechanism for settling disagreements since the parties can turn to alternative sources if they are dissatisfied. Spot-market transactions are satisfactory. In many other transactions "bilateral dependency" is present. Spot markets are inadequate for coordinating activity between agents and sophisticated forms of dispute resolution are needed. When bilateral dependency is moderate, long-term contracting can be efficient. As the level of bilateral dcpendcncy grows, hierarchical control is more efficient.

The most difficult type of governance system to support is long-term contracting. Both parties to the contract are "vulnerable" because of bilateral dependency. Contract law takes on increased significance in these setting, but other, private means, of dispute settlement are also important. If these contractual support systems are not present

> viable middle range transactions will flee to one of the poles -- by moving to the spot market (attended by the sacrifice of asset specificity and resuiting loss of productive value) or by moving to hierarchy (with the added bureaucratic cost load). A high-performance economy will support transactions of ail three kinds rather than force polar choices... The quality of an economy's contract laws and enforcement efforts (including its permissiveness, or not, toward private ordering) can thus be inferred indirectly by the evidence on hybrid contracting (rather than directly, by examining the laws and the qualifications of the judiciary). (Williamson, 1994, p. 18)

Thus the complexity of observed contracts can provide evidence on the transactional efficiency in an economy. There may be other constraints in the Bulgarian case, however. After the brcak up of many largc statc cntcrpriscs in Bulgaria, “fleeing to hierarchy” may be circumscribed, although less so for private firms. This could be another form of inefficiency since firms may be forced into using long-term contracts when hierarchy would be appropriate given the governance support for long-term contractual relations. In addition, Clague (1993) emphasizes the importance of effective government in enforcing contracts; Bulgarian courts and police have not traditionally had any experience or capacity in helping the private sector enforce contracts.

Klein, Crawford and Alchian (1978) emphasize that the problem of reneging on contracts is important only when there are “appropriable specialized quasirents.” When these exist, vertical relations, such as a single firm, are generally advantageous. They also note that market power is pervasive, but bilateral market power will tend to lead to vertical integration. They argue, using examples, that a legally enforceable contractual solution is not feasible. Any solution must be enforced by economic power.

Economic enforcement can be developed by placing assets in the hands of the party which values them most. For example, assets that are particularly valuable to one party (such as orchards) may be leased to that party. Social institutions, such as close-knit club memberships, create complex ties that enforce contracts, since members are expected to continue to interact with other members. (See Fudenberg, Holmstrom and Milgrom (1990) for a more formal analysis of contracts based on repeated play.)’

Ellickson (199 1) studies the application of Coase’s cattleman-rancher example of

[8] This point has recently been developed further in the literature on banking and credit (Lamoreaux 1994).

contractual solutions to property rights problems by interviewing people in Shasta County, California. He discovered that community norms developed to solve such cattle-rancher problems as trespass, outside of court. The outcomes from application of these norms were quite different from the legal remedies, and inconsistent with people's actual legal rights. People rarely resorted to the use of lawyers or courts except in cases where motor vehicle accidents occurred and people driving the car were from outside the community. From his study Ellickson develops a thesis that "members of a close-knit group develop and maintain norms whose content serves to maximize the aggregate welfare that members obtain in their workaday affairs." (p. 167)

An important problem in countries going through the transition is the changing nature of relations between economic agents. For example, under central planning it was not important if suppliers were paid. Managers were rewarded for fulfilling the dictates of the plan. When monetary exchanges replaced plan directives, there were no existing norms within the business community regarding appropriate behavior for the new circumstances. The large arrears in payments between firms that surfaced during the transition period in many countries represented a continuation of past practice.[9]

Few Bulgarians have much experience working in markets. Some people who had international trading experience (usually with the specialist foreign trade organizations) could use

[9] Smith and Schnucker (1994) examine the decision to extend trade credit to customers. This problem is one faced by -most of the larger firms we examined in Bulgaria. They find that many firms "engage factors occasionally as lenders ex post to meet short-run financing needs." We also observed some firms that engage in the more narrowly defined business of factoring, particularly involving foreign trade. For their large U.S. sample, around 20% of firms in manufacturing use factors, with a similar share in the food industry. However, only 13% of firms in wholesale trade use factors. Two thirds of the firms using factors are involved in foreign trade. Around 80% of firms in both manufacturing and wholesale trade offer customers trade credit. Explanations for factoring center around standard Williamsonian transactions costs.

this experience and apply it to the new situation. But even for these people, the environment in Bulgaria is not quite the same as in the international arena. International traders had been dealing with people with extensive experience in market relations. Within Bulgaria, many people had no market experience at all before 1991.

Macaulay (1963) interviewed American businessmen, largely in manufacturing and machine-building, regarding their contractual relations with other business people. He found that most purchase agreements were considered to be orders, not contracts. Not taking delivery was not considered a violation of the contract. Careful detailed contracts were often considered inappropriate because “planning indicates a lack of trust and blunts the demands of friendship, turning a cooperative venture into an antagonistic horse trade.” (p. 64) Businessmen preferred keeping lawyers at a distance. Court action was generally reserved for situations where the monetary stakes were high or the firm expected to terminate a business relationship.

Macaulay reported that in most instances "[b]oth business units involved in the exchange desire to continue successfully in business and will avoid conduct which might interfere with attaining this goal.” (p. 63) To promote this continuity, norms developed where "[c]ommittments are to be honored in almost all situations, one does not welsh on a deal...One ought to produce a good product and stand behind it (p. 63) A man’s word or handshake is seen as binding as a written contract.

The business environment Macaulay described was largely the purchase and maintenance of large pieces of machine-building equipment, such as milling machines and presses. In general, the firms expected their counterparts to be in business for a long time, and the specific buyers or salesmen expected their counterparts to be in their positions for a long time. Thus, the environment was stable and conducive to stable business relations.

The environment Macaulay describes contrasts sharply with the environment that existed under central planning where commitments and rewards came from the central planning hierarchy, not trading partners. Furthermore, the norm that Macaulay described "to produce a good product and stand behind it" reflects an environment where quality and service are respected and marketing your product is crucial. In the central planning environment where supplies were scarce, quality tended to be poor and there was no need to market products since the plan determined where output should be sent.

Macaulay's study raises a number of questions regarding business relations in Bulgaria. If business firms rarely go to court in the U.S., what will firms do in Bulgaria where the court system appears much weaker? Are businessmen confident that trading partners will honor their commitments? Do business people have an expectation of long-run relationships, or do they expect these to develop over time? Will businessmen feel the need for detailed contracts or will this be considered a breach of trust? As western goods appear in stores and many enterprises suffer as the demand for their goods drop, how will business relations adjust to the new demands for higher quality?

Some of these questions have been addressed in the context of the Russian transition. Tourevski and Morgan (1993) describe the "business culture" of Russia, showing differences with the U.S. For example, "Americans rend to underestimate the typical inability of the Soviets to think along legal lines, the extent of their mistrust of laws and rules, and their reliance on personal relationships. In the Soviet way of doing things, hardly any business can be developed without personal ties (p. 188)." This source also emphasizes that businesspeople see the benefit of business relations as an opportunity to take advantage of others. not to allow mutual gains from business dealings.

Rubin (1993) emphasizes the difficulty of relying upon legal enforcement of contracts in transition economies. He argues that any transition economy will have difficulties in developing a full-blown system of contract law, since any system of contract law requires a set of working institutions and also common working understandings by businesspeople. A process of mutual adjustment of expectations and understandings, and "evolutionary" process in some sense, is required to develop these mutual adjustments. Rubin also provides evidence of substantial opportunism in post-communist contractual relations. He reports cases "of the simplest forms of opportunism. Firms in Russia sometimes take money and provide nothing; at other times, they accept goods and then do not pay. Enforcement even in these cases is apparently difficult (p. 18)."

Rubin also notes that "even in developed countries, explicit enforceable (and enforced) contracts are relatively unimportant for much exchange. To the extent possible (and it is a large extent) businesses rely on agreements and do not use enforceable contracts..." He continues, "in the U.S. 75% of commercial disputes are settled privately through arbitration and mediation," services available, but not yet heavily used in Bulgaria.

In describing self-enforcement of contracts, an essential element is that each party must benefit from transactions, and this gain must be greater than the gain from cheating. Rubin notes that this concept of conceding to one's partner a significant profit as a matter of policy is unusual in Russia. Mutual hostages are also a possible mechanism.

Multilateral mechanisms, Rubin believes, are potentially very important. Trade associations and related groups, particularly when using arbitration, can be very effective here. Reputation can also be useful, although Rubin does not consider this particularly valuable.

Clague (199 1) argues that less developed countries are poor not due to a lack of capital, but due to the lack of proper contract enforcement and of the trading structure that would be used more fully if contracts were adequately enforced. We should draw the lesson that contract enforcement seen broadly is very important to the countries in transition eventually becoming wealthy.

Technological factors are emphasized in Paley's (1984) study of contracting for railroad boxcars. Paley interviewed both rail carriers and shippers to determine how they contract with one another. Specifically he was concerned with how they enforce contracts. He found a wide spectrum of contractual forms depending on the degree of idiosyncratic investment needed to ship the goods and the expectations about the future of the relationship. Where standard boxcars could be used, agents depended on market forces to enforce contracts. At the other end of the spectrum were chemical cars that could be used only with particular chemicals. The chemical companies owned these cars, a form of vertical integration. Between these two extreme were situations where rail cars could be modified for specific purposes. In these intermediate cases trust relationships developed. Paley gives an examples where $1.5 and $2 million idiosyncratic investments were made based on trust between carrier and shipper. These situations involving an intermediate degree of specialization had the most complex contracts.

Sako's (1992) study provides cross-cultural perspective on these issues. He compares contractual behavior in Britain and Japan. Sako finds that the relationship between Japanese firms are closer than between British firms. He distinguishes between arms-length bargaining which is more common in Britain and obligational supplier-buyer relationships which are more common in Japan. Obligational relationships create more mutual interdependence and as a result require that parties trust each other more. With trust trade secrets can be shared and the firms can save on monitoring costs.

Trust plays an important role in Sako's analysis. He breaks trust down into three elements: contractual trust where there is "mutual expectation that promises made are kept"; competence trust where there is "confidence in a trading partner's competence to carry out a specific task;" and goodwill trust where there are "mutual expectations of commitment to the relationship resulting in much give and take." (p. 242) Goodwill trust depends on a sense of fairness which is understood by both parties.

But what exactly is meant by "trust"? Gambetta defines trust as

> . ..a particular level of the subjective probability with which an agent assesses that another agent or group of agents will perform a particular action.... When we say we trust someone or that someone is trustworthy, we implicitly mean that the probability that he will perform an action that is beneficial or at least not detrimental to us is high enough for us to consider engaging in some form of cooperation with him." (p. 217)

If "a particular level of subjective probability" is needed for trusting relationships to form, how **is this level** to be achieved? Dasgupta **(1988),** who has studied trust in a game theoretic context, sees trust developing through reputation achieved by repeated interactions. This contrasts with Hackett (1994) who describes laboratory results that find conditions for attaining equilibrium for an incompletely specified contract. Basically, despite anonymity and a lack of repeated play for individuals, the agents developed rules of behavior **that** are related to the amount that parties invested in the relationship. The indication is that "rules of fairness" that are actually efficient can **develop even** in the absence of repeated play.. Williamson (1993) suggests several other factors that could influence subjective probabilities: societal culture, politics, regulation, professionalization, networks, and corporate culture. These are not always supportive of greater trust, as Banfield (1958) has pointed out in reference to culture.[10]

Williamson emphasizes the importance of opportunism in business relationships, where individuals may use clever and unsuspected ways to benefit themselves at others' expense. But there may be degrees of opportunism, and "trust" may refer to cases where people expect that others will not exercise the maximum degree of opportunism."

These studies suggest that many factors play a role in the governance of trading relationships. Because so many things are changing so quickly in Bulgaria, factors which might contribute to trust building among economic agents are presently absent in the Bulgarian context. This should limit the types of transactions which will take place. Because the movement to a market economy in Bulgaria is so recent, difficulties in establishing trading relationships are to be expected. An alternative method of enforcing contract is to resort to Mafia-type methods. Beyond the inherent dangers associated with such methods, they can be very inefficient since they depend on the relative strength of various groups (Greif and Kandel 1995). Weakness in law enforcement bodies does create the potential for such activity, however.

---

[10] Casson (1991) develops a straightforward model of culture as a factor in building trust in business relationships. While Casson considers many cases in a simple game-theoretic model, the overall idea is that when a climate of trust can be created, business will benefit from all agents relying upon the expectation that others will act in accordance with their promises.

[11] Williamson (1993) has questioned the use of the term "trust." He argues that, except where there are close personal relationships, to trust means that the economic agent has done a calculated risk assessment of good and bad outcomes and has concluded that action is worth the risk. He prefers the term "risk" rather than trust since he argues it is less ambiguous. One would not use "trust" to describe a case it which it was obviously in the immediate financial interest of all parties to fulfil a contract--say, one buys a soda and pays cash. Carswell (1993) has less difficulty with the term trust if the author explains how trust comes about.

Still another method of enforcing contracts without recourse to law is the close-knit group. This has been studied in a variety of contexts, such as ethnic groups (Landa 1994, Greif and Kandel 1995), city elites (Lamoreaux 1991, 1994), and zaibatsu. Lamorcaux (1991, 1994) gives a particularly clear description. In early 19th century New England cities, a clique of businessmen established a kind of informal group, typically including a bank. The members of the group had a variety of separate enterprises, but thc bulk of these were partnerships involving several group members. Loans were typically obtained from the bank, which was directed by the leading members of the group. Thus, each group member was tied to the other members by a web of relationships. Failure to carry out commitments meant great difficulties with the other members of the group, and evidence of opportunism was sufficient to end a person's business career immediately.

Groups of this sort appear to be flourishing in Bulgaria. There are press accounts of group which has become known as the "G-13" (a take-off on the G-7 countries), which includes investment banks and trading and manufacturing firms. Lending goes on among group members. However, one member of the G-13 is well-known for its "wrestlers" who reportedly enforce contracts with mafia-type tactics and also discourage competition against G-13 members (according to Bulgarians we interviewed)." Since summer 1994, this "group" has split up, and most recently had seven members (Transition March 1995, p. 5).

Other Surveys of Businesses in Eastern Europe

While not related directly to our concerns, the World Bank has organized a number of surveys of businesses in Eastern Europe that have some relevant findings. Two papers examined

[12] Personal observation of "bankers" from one well-known investment banking firm indicated very well-paid, powerful young men who liked to show off their physical strength.

firms in St. Petersburg. Webster and Charap (1993) examined new private manufacturing firms. They conducted in-depth 3-4 hour interviews with these firms. They found that a considerable share of private firms were closely associated with state enterprises as junior partners, something we did not observe in our sample of Bulgarian firms, but had heard about occasionally. Firms averaged 63 workers. About half of the firms had received loans, and about half of these were from banks. Competition was reported to be less than in our sample, with one third of firms reporting no competitors, and another third few. Firms largely made and received payments through the banking system, despite its inefficiencies, although there were considerable cash payments as well.

De Melo and Ofer (1994) interviewed a sample of private service firms in St. Petersburg. A majority of these firms have ownership stakes in other private companies, a pattern we noticed casually in Bulgaria. Several firms were members of groups (p. 15). Some were connected with banks, in order to obtain financing. High profits in trade were noted, but these were now declining in the food business. "Financing patterns for firms in St. Petersburg were typical of financing patterns for small private companies elsewhere in the world. Most financing at the time of establishment came from the owners' own resources, and most financing for subsequent operations and investment came from internal profits." (p. 21) This was also true in Bulgaria, but owners in Bulgaria seemed to believe that banks should provide them with loans. Most service firms in St. Petersburg had serious competitors. The legal system was criticized, with changes in the law a big problem and backlogs in the courts noted. Some used government-sponsored "arbitrage" (arbitration?) facilities. The bulk of transactions went through the banking system, but there were considerable cash transactions, particularly for "under the table" reasons,

Webster and Swanson (1993) surveyed private manufacturing firms in the (then) Czech and Slovak Federal Republic in January 1992. The average number of employees was 42. Firms were typically started by groups of friends and former co-workers (p. 28). "...two thirds of entrepreneurs in the former CSFR had received loans within six months of start-up (p. 32)." Banks required considerable collateral, however. Firms had trouble collecting payments, and some eventually required cash payments up-front.

Frydman et. al. (1994) discusses privatization in Central/Eastern Europe. Most interesting is the report from the survey that "credit from suppliers is virtually unavailable for financing working capital" in the Czech Republic, Poland and Hungary. "Supplier credit is the usual mode of financing retail businesses in mature economies, since monitoring small business is too costly for banks and other creditors in relation to the size of the loan. Suppliers, on the other hand, because of their ongoing relation with the retailers, are in a better position to oversee retailers' activities." (p. 70) "The absence of supplier credit in Eastern Europe is most likely due to high interest rates coupled with the newness and transitional state of many of the relationships between suppliers and new owners of retail establishments. The turmoil in the wholesale sector is probably a contributing factor as well." (p. 70)

"Contrary to the concern of many Westerners, the respondents do not seem to be very worried by difficulties with contract enforcement, but they do worry quite a lot (especially in Poland) about "legal uncertainty," by which they most probably mean the insecurity of property entitlements. (p. 73)" In the survey, the following numbers of respondents noted "Lack of Procedures to Enforce Contracts with Customers and Suppliers" as a perceived constraint on their activities: Czech Republic 11 of 97, Poland 7 of 99, Hungary 7 of 98. In the United States, intentional failure to pay is a crime (fraud), and is actively prosecuted, but we did not see any evidence of this occurring in our interviews (Wall Street Journal, April 26, 1995, p. B2).

IV. Survey Procedure

In preparation for the interviews our team developed a survey form during Spring 1994.[13] The survey form was then translated into Bulgarian.[14] The English and Bulgarian versions of the form can be found in Appendix A. During June 1994 interviews were conducted with thirty-six businesses. In most state-enterprises the survey was conducted with the manager of the enterprise ("Director" in Bulgarian) or the assistant director. In private firms, the owner or manager was interviewed.

Since it would be easier to understand the common problems of a given industry, we preferred to concentrate on one sector with a readily understood technology. Since it includes a variety of ownership types, we concentrated on the food processing and food distribution sector. We also decided to include some firms from outside this sector to see if our earlier observations could be generalized. Twenty-eight of the thirty-six interviews were conducted with firms in this sector."

The sample of thirty-six firms was developed by contacts we had developed during previous visits to Bulgaria. This differs considerably from the techniques used in World Bank studies of firms in Eastern Europe and the former Soviet Union. For example, Webster and Charap (1993) in their study of private firms in St. Petersburg went through registries and then interviewed firms which responded to letters. While our method of selecting interviewees creates

---

[13] We designed the survey using standard techniques for "semi-structured surveys." See particularly Devereaux and Hoddinott (1993), which emphasizes difficulties in obtaining sensitive information, and suggests ways to gain the confidence of businesspeople.

[14] The Bulgarian version was then translated back into English to check accuracy of the content. The survey form was also tested in six preliminary interviews before the arrival of the interview team in June.

[15] Others were in tourism, trading, and manufacturing.

biases in the sample, it also created a more open environment for conducting the interviews. The atmosphere in almost all the interviews was extremely cordial.[16] We were accompanied to all interviews by a Bulgarian who was at least indirectly acquainted with the person to be interviewed, which helped with creating a feeling of trust. Responses appeared to be honest and straightforward (indicated by the numerous times they brought up errors or problems in the operation of their business). Most interviewees were comfortable answering the questions. Probably this was because the questions dealt with how they engaged in trading relations rather than the financial condition of the firm. Managers were being asked to describe in large part how they would deal with common business problems, something they probably discussed regularly with other businesspeople." On several occasions when a question touched on a sensitive issue, the interviewee simply declined to answer. Of the thirty-six interviews, thirty-three went extremely well.[18]

Because of the selection technique, there are biases in our results. For example, we were shown more privatized firms than we would have found in a random sample. We also suspect

[16] One interview began with the person expressing concern about giving out financial information because of mafia activity. About two-thirds of the way through the interview, he volunteered that it was a pleasure to talk about his business to someone who was not trying to take advantage of him.

[17] In the U.S., effective ways of dealing with these types of problems is the common subject of business conversation, both among friends and at such occasions as Rotary luncheons.

[18] The three problems were as follows. In a small private firm, the person did not understand many of the questions being posed. In one state-enterprise there were two representatives in the room. One person carefully watched the other person respond. The atmosphere was reminiscent of the Communist era when speakers were often watched during presentations or interviews. In a third case the interview was very tense from the beginning. The tension eased as the interview proceeded, but there were inconsistent responses to several questions.

that we saw a higher proportion of successful firms than a random sample would have generated. (Our contacts wanted to show us successful business operations rather than failing businesses.)[19] This bias would have been more important if we were studying the success of Bulgarian businesses rather than their inter-relations. In terms of possible distortions in the results, it is our sense that the openness of the interviews more than compensated for this sample bias.

The interviews lasted, on average, approximately an hour and one-half. In most cases there were four people in the interview team, which included two investigators, an interpreter and a notetaker. When a notetaker could not accompany the team, a tape recorder was used.[20] In some of the later interviews, only one investigator took part. The interviews began with one investigator giving a brief description of our team and its background. Then the interviewee was asked to describe his or her business. (Here we were following customary Bulgarian etiquette. We would also be served beverages at this stage.) The manager was then asked to sign the release form, and then we proceeded to the questions from the survey. Many responses were far more elaborate than the choices provided in the survey document. As the survey proceeded, the investigators asked additional followup questions to elicit more microanalytic details about the operations of the specific firm. Thus, if a manager mentioned a problem in enforcing a kind of contract, we would ask a series of questions to come to understand the reasons for the problem

[19] Still, we interviewed a number of state enterprises that were producing at a small fraction of capacity and/or admitted that they were doing poorly.

[20] The interpreter and notetaker were people trained in economics and business. Despite initial concerns on our part, it turned out that only one interviewee objected to the use of the tape recorder.

Before beginning the interviews we requested that the interviewee sign a confidentiality agreement required by U.S. law for interviews with human subjects (see Appendix B.) As this was a very unusual request in Bulgaria, we were concerned that managers would be hesitant to sign this statement. On only two occasions was this a problem. In both instances it was resolved amicably and we received the required signature.

and the manager's method of dealing with it. The survey form was not followed strictly in its entirety as circumstances sometimes required changes, but the interviews followed a pattern where most questions were almost always asked." It is, therefore, possible to compile statistical results on most, but not all, questions.

In addition to our formal interviews, we consulted with a number of experts on Bulgarian conditions and laws. We spoke with a USDA representative, Clay Hamilton, about agricultural conditions and problems of privatization. A representative of Land 0' Lakes provided information on conditions in the dairy industry. Also, the executive director of the Chamber of Commerce in a moderate-sized city described the operation of the arbitration system in Bulgaria. A Bulgarian and an American lawyer with the American Bar Association's Central and Eastern European Civil Education Project described the effectiveness of the Bulgarian court system in dealing with cases of commercial law, and the Bulgarian lawyer in a second interview also detailed procedures for assuring payment under Bulgarian law and court orders.

A banker with a major Bulgarian bank described the procedures and principles of offering loans. A representative agent for Dun and Bradstreet described the methods and extent of the business of investigating other businesses to assure that they were reputable.

V. Institutional Change

A. initial Institutional Conditions

[21] When managers gave the answers to some questions during their beginning presentation, for example, we avoided answering the same questions again. Sometimes the details of one question would give the answers to a later question. In several cases, the firm did not deal with commercial suppliers. or with commercial customers, so those questions were omitted.

Several important characteristics of the Bulgarian economy under central planning defined the initial institutional conditions for the transition to a market economy. Since the economy was organized as a hierarchy, the relations between economic units were similar to those found between units of a large western firm. Instructions were given from the central planners to the directors of enterprises to deliver output to specific firms. Inputs were also received by instruction from the center. There was great continuity over time since enterprises could expect to deliver to the same customers year after year and receive inputs from the same suppliers. Thus, there were well-established relations between enterprises.

While the transformation of these hierarchical planning relations into corresponding market trading relations seems logical, there were several difficulties which would have to be overcome. When enterprises became independent profit-centered units within a market system, they no longer shared common objectives. New agreements which reflected the new relations between enterprises were needed. Many issues which had previously been resolved between the enterprise and the center now had to be resolved between enterprises. Not only did decision-making authority shift, but the central planners were no longer available as referees. The courts or the market would now have to fulfill this function. So even in situations where managers of enterprises knew one another, the relationship between them was redefined.

The movement away from hierarchical relationships has also created the possibility of additional sources of supply and new customers. Since the movement of goods through the production process is no longer dictated by the central planners, state enterprise managers can now trade with new partners from either the state or private sector and with foreign or domestic firms. This flexibility presents new challenges since trading with new partners means dealing with people with whom the managers have not previously worked (although Bulgaria is small enough that in many cases the managers do know one other).

In hierarchical organizations, internal accounting systems monitor the movement of goods between units, but this is not the sarne thing as money being exchanged in a market between firms. Under central planning a type of money (in the form of bank deposits) was used to account for transfers between firms, but it was restricted in its use. For example, the money could not be used to pay wages. When the transition began, many firms did not pay their suppliers, and arrears quickly grew. In Bulgaria, as in other countries, the growth of these arrears seems to have stopped (Baer and Gray 1994, Dobrinsky 1994). Suppliers no longer deliver goods unless they are going to be paid.[22] This suggests a recognition that the situation has changed and that firms need new enforcement methods.

The difficulties in defining new relationships were exacerbated by the decision to break up existing enterprises. Central planning encouraged the development of large enterprises so that the economy could be more easily controlled. While the breakups of firms may have increased competition, they also created many small new units which had to find new ways to interact with one another. In contrast to a market economy where production units evolve to improve efficiency or achieve market power. the decisions on breaking firms up were made centrally.[23] Some of these new units might more naturally be combined.

Central planning created an environment of excess demand in which quality suffered, Market systems are less tolerant of poor quality goods. Because Bulgaria exports close to half its production, this adjustment has been particularly difficult, for even if Bulgarians are tolerant of

[22] The exceptions are deliveries to hospitals, schools and military bases.

[23] In making these decisions the government seemed to have relied on the naive view that the smaller the firm the better. For example, one power engineering firm was divided into a planning and drafting unit, a research unit and a construction unit.

low quality goods, it is difficult to export such goods to Western markets (which are essential now that ex-socialist markets have collapsed).

The movement to market relations, therefore, created pressure for substantial institutional change, Managers have more discretion to make decisions and define their interactions, but their flexibility to merge with other units or privatize all or part of their enterprise is still severely restricted. There is also pressure to produce high-quality goods and increase sales rather than just increase production. This, along with excess production capacity and a fall in overall demand, has greatiy increased the relative power of buyers compared to suppliers. Overall, firms face a strong need to learn customers' demands and respond to them.

B. What Institutional Changes Might be Predicted?

Institutions create efficiency by routinizing tasks. Pressures for change face strong inertia to maintain existing patterns. For instance, if firms have a long history of supplying certain customers and receiving inputs from particular suppliers, it would seem natural to translate these (hierarchically determined) relationships into market trading relationships. There are efficiency reasons for maintaining these relationships as well. For example, many plants were built in close proximity to their suppliers and customers. These enterprises are natural trading partners, especially where poor infrastructure limits potential transactions with other firms.

At the beginning of the transition it is natural to expect that many old relationships would develop initially into bilateral bargaining situations. This is especially true where firms have actually been broken apart, but it would also be the case where relationships have a long history and the two parties are driven together for efficiency reasons. If asset-specific investments have previously been made, the enterprise will suffer losses if old relationships are not maintained.

Under these circumstances, either integration or long-term contractual agreements would lower transaction costs. Integration, however, is not an alternative if enterprises have been purposely broken apart to create competition and mergers are not permitted. Long-term contracts present the most difficult governance problems since they involve complex agreements to work together in an uncertain future (Williamson 1994). Long-term contracts would be especially difficult to sustain in an environment where the trading partners find their relationship has been redefined by the switch to the market. Since they also have had limited experience in a market environment. it is difficult for them to foresee the contingencies they will face in a long-term contract. Institutions that support contracts, like the courts, are also feeling their way.

The alternative to long-term contracts or integration are transactions where there are few asset specific investments, and almost no quasi-rents will be lost if the relationship is broken. To distinguish this type of transaction from long-term contracts, we will refer to them as spot- market transactions, although they typically involve a series of fairly simpie transactions over an extended period of time. For instance, a contract in which suppliers promise to make several deliveries of a standardized product will be classified as a spot-market transaction.[24]

Williamson (1994) argues that a better test of transactional efficiency than looking at the operation of the courts is the observation of complex long-term contracts. In the Bulgarian context where integration is difficult, the absence of long-term contracts limits the ability of firms to produce specialized goods that will increase economic efficiency. We observed relatively few complex long-term contracts. But a number of firms described cases in which the lack of such contracts had led to large losses. On the other hand, there is a growing awareness of the

[24] We have found that these arrangements are more complex than Williamson suggests. Klein, Crawford and Alchian (1978) point out there can be many relationship-specific investments even in situations which involve basically trades of money for goods.

importance of maintaining good long-term relationships with trading partners. This is a result which we did not expect before doing the survey.

Contrary to the standard view of spot market contracts, we found that even these contracts can develop problems and lead to high transactions costs. Broadening the set of trading partners, as many firms appear to be doing, brings protection against the vagaries of bilateral bargaining, hut interaction with new unfamiliar people alsn has its hazards. Many of the problems described by our interviewees are difficulties in implementing reasonably straightforward spot market transactions.

VI. Survey Results

Table 1 presents the characteristics of the sample which participated in the interviews. The majority of firms were in food processing and distribution. The others are in a variety of other businesses. Our sample reflected the institutional arrangements that are now evolving in the food processing/distribution sector. There are very few state firms still involved in retail distribution and there are relatively few private firms in food processing. There are cooperatives involved in both food processing and distribution. In many instances private farmers sell to state firms which process the food. The food is then distributed through private retailers. We give a more complete description of the individual firms in Appendix B. Since we promised confidentiality to the firms, facts that might identify them are omitted. Appendix C includes a detailed set of answers to the questionnaire.

TABLE I

Characteristics of Sample

Main Product or Service

Food production	19
Food distribution	**10**
Other **	8

(including tourism (2), shoe manufacturing, packaging, market research, transport broker, sportswear, trading firm)

N= 36

Type of ownership

state	17
private	11
cooperative	5*
municipal	2
joint-venture with foreign participation	1

N = 36

(One cooperative reported to the Council of Ministers)

Food Industry Ownership Type

	Processing	Distribution
state	11	1
private *	3	5
cooperative	2	4
municipal	2	0
joint-venture with foreign participation	1	0

N = 29

(Some firms are involved in both processing and distribution.)

Profitability

highly profitable	3
profitable	24
not profitable	**4**
new firm	1
refused to answer	1

N = 33

Firm size

number of workers . . . . mean 277 . . . median 145 N = 30
sales (millions of lev) . . mean 345 . . . median 80 N = 28

Size Range

number of workers ... 1 - 2800 (excluding highest and lowest: 7 - 820)
sales (millions of lev) .2 - 5,000 (excluding highest and lowest: 20 - 500)

Years in business

1-4	9
5-8	2
9-16	.3
17-24	.5
25-32	.4
>32	4
N = 27	
median	.16

Most firms in the survey reported that they were profitable. In part this reflects the fact that conditions in agriculture are better than they are in many other sectors of the economy. The responses to this question may also be biased, since no attempt was made to carefully define what profitability meant. Another explanation is that this response reflects biases resulting from a sample selection technique where people were more likely to direct us to more successful firms.

The majority of firms had also been in business for a substantial period of time. These were not “fly by night” operations. The median number of workers was 185. As we will see below, these firms have gained experience in the market and-learned the importance of establishing good trading relationships with their trading partners.

The reporting of the remaining survey results have been organized in terms of the Williamson theory of contractual types. While all three types of relations - spot market, long-term contracts, hierarchical reorganization - are utilized to solve transactional problems, our survey reveals that the predominant relation is spot-market interaction. As Table 6 shows, a large majority of firms insist on up-front payments. We will therefore focus on how spot markets are evolving. Spot market arrangements are improving, reducing transaction costs. Eventually, as these arrangements become more sophisticated, they should lay the foundation for more widespread use of long-term contracts or long-term relationships of the type described in Macauley (1963) and Fudenberg, Holmstrom and Milgrom (1990). We begin our presentation, however, by describing situations in which hierarchical change and long-term contracts are already being observed and identify why they are not more widespread.

A. Hierarchy

If Williamson is correct, the constant change in organizational structure that occurs when firms merge, acquire other firms or sell off subsidiaries is a search for more efficient organizational forms. In Bulgaria, this kind of activity is also taking place, but it is largely confined to the new private firms and to cooperatives.

Before 1989 many cooperatives not only produced agricultural products, but also had retail outlets through which these products were sold. The workers in these cooperatives have effectively been given control over their firms. They are now operating as independent self-managed enterprises. In several interviews with cooperatives, we found that the retail and the production elements have split and are now independent units.

For new private firms, mergers and splits often relate to problems of obtaining sufficient financing. (In many private firms personal relationships are also decisive in determining whether partnerships form or break apart.) Production units may merge with trading units which generate more cash flow, in order to finance larger capital expenditures with slower paybacks.

Alternatively, the formation of private banks supported by several businesses can provide a means of financial support for members of the group.[25] That so much reorganizational activity focuses on financing emphasizes how difficult it is to obtain financing through capital markets in the present environment.

Other interviews demonstrated how limited merger and acquisition activity is, however. For example, one privatized state enterprise complained that the quality of an important input was inadequate. The former state enterprise was frustrated in its attempts to convince the other firm to improve its quality. Even though the firm knew that there was more than sufficient capacity to produce this input in the region, it still planned to build its own plant rather than purchase the other firm (since the other firm could not legally be purchased). Another example is a firm which found itself in a declining industry. The management decided to expand into production in a related area. Rather than look for a merger partner, the firm built new capacity even though excess capacity already existed.

B. Long-term Contracts

While enterprises are finding it advantageous to maintain long-term relationships with trading partners, their interaction tends to be a series of spot market trades rather than a formal long-term contract as is frequently found in the U.S. (or Japan).

The most common long-term contractual relationship that we found in the survey was joint venture activity with foreign partners. The principal motivation for Bulgarian firms is the additional financing that foreign partners can bring. These relations tended to be stressful and

[25] Under Bulgarian banking law, banks are limited as to the percentage of assets that can be loaned to one customer. By forming groups each member can obtain financing from the bank and still not exceed the maximum loan size.

"difficult" for the Bulgarian firm. This tension may explain, in part, why foreign investment in Bulgaria has thus far been so limited.

We also found a few other examples of long-term contracts. One firm that was receiving extensive advice from foreign agricultural specialists had formed a "closed circle" of feed grain, meat production and marketing. Another state firm, a food processor, attempted to maintain close control over its agricultural suppliers. The firm still purchased 90-95% of local production. It lent money to local growers and provided fertilizer and pesticides, and viewed it as "immoral" if suppliers sold their output to other food processors. When asked what the firm did if a supplier tried to sell to another firm, thc intcrvicwcc responded that the firm set out to convince the grower of the importance of long-term relationships.

Another firm described several innovative arrangements for sharing its facilities. The firm has a profit-sharing arrangement with a seed producer where the seed producer uses the firm's land. This firm also had a contract which had interesting arrangements for collateral. The firm placed some of its sheep on the property of another firm in the mountains. In exchange the other firm has henhouses on the property of this firm. The hens were viewed as collateral which could be seized if something happened to the sheep in the mountains.

As this last example illustrates, policing and maintenance of long-term contracts is difficult. This is why we observed so few. This last firm admitted that it had little confidence in the court system. As can be seen from the example, it also had limited trust in its trading partner. Still, the firm was able to design a somewhat awkward but satisfactory contractual relationship.

C. Spot Markets

Where the level of asset specificity is low, simpler governance arrangements are possible.

Still, there can be serious problems when markets just begin to form. We divide spot market transactions into four parts. The first two apply to pre-exchange costs-- 1) identification of trading partners, 2) bargaining to reach an agreement. The last two relate to problems of enforcement of the agreement-- 3) non-legal controls 4) court action.

1) Identification of Trading Partners

As firms shift from hierarchical relations to market relations, they must identify worthy trading partners. At the beginning of the transition it is not clear that business people understood the value of reliable trading partners. It was our perception before doing the interviews that many business people regarded long-term relationships as unimportant. The way to make money was to make a quick deal where the profits were large and move on to the next deal with someone else.

In contrast, firms in the survey, most of whom have been in business for two years or more, emphasized the importance of trust. They try to find business partners who are reliable and then work with these partners on a continuing basis. Serious business firms understand the importance of long-run relationships.

Finding good partners in the present environment is not easy. Many firms in the survey sample had been taken in by "phantom firms" which appeared in great numbers during earlier stages of the transition. These phantom firms went into business to obtain large "trading profits" from a single big deal. Phantom firms take advantage of other businesses by failing to pay for goods, or by receiving payment and failing to deliver.

While they may have been naive at first, firms now protect themselves from such firms by doing a careful evaluation of trading partners and insisting on up-front payment terms. For example, the manager of several retail groceries was asked what he would do if approached by a new supplier. He responded immediately with a list of four conditions that he uses to evaluate new prospective suppliers: 1) If the supplier offers a low price for a product in high demand, then he is suspicious. 2) If the supplier agrees to all the terms that are dictated to him even if they are disadvantageous to the supplier, again this manager is suspicious. 3) A clear time frame is established for delivery to see if the supplier can meet the conditions specified; if the goods do not appear, the manager breaks off relations with the supplier. 4) The manager never pays before seeing the product.

With such a high degree of suspicion on both sides, the effort required to evaluate trading partners is costly. Firms are making a significant asset specific investment in finding a reliable partner (as in Klein, Crawford and Alchian 1978). Quasirents are lost if the trading relationship is terminated. Since it is expensive to find new partners, there is a high probability that some beneficial exchanges will not take place.

In this atmosphere, firms now understand how important their reputation is. Because it is very costly to find reliable trading partners, it is important to keep a good relationship with existing partners. Indeed, as Table 2 indicates, almost all firms had a core group of partners with whom they traded frequently. Furthermore, their relationship with both suppliers and customers was positive.

A good relationship with trading partners also makes it possible to obtain trade credit. Most firms insisted on up-front payments in any new relationship, but- over time these conditions were generally relaxed as people got to know one another better. Greater flexibility lowers transaction costs in an environment where payment is uncertain and needs for cash are often unpredictable. Trade credit is also highly valued since nominal interest rates are so high.

TABLE 2[26]

Suppliers:

Core group of suppliers?

yes	35
no	1
N= 36	

Proportion of sales from core group:

below 25%	2
from 25% to 50%	8
from 50% to 75%	9
above 75%	11
N = 29	

Relationship with suppliers:

friendly	14
trustworthy	21
hard bargaining	2
not entirely trustworthy	1
other	0

[some multiple responses in the first two categories]

N = 26

Customers:

Core group of customers?

yes	32
no	1
N = 33	

Sales to core customers:

below 25%	4
from 25% to 50%	6
from 50% to 75%	6
above 75%	13
N = 26	

Relationship with customers:

[26] Note that throughout the tables there are often multiple responses from a single firm.

friendly	6
trustworthy	17
hard bargaining	2
difficult	0
correct relations	1
N= 21	

The development of a variety of new market arrangements is assisting the search for new trading partners and enhancing the efficiency of trading relationships. For example, active commodity exchanges for wheat now exist in Sofia and Dobrich. Forward contracts exist. Each side puts down 3% and the bourse holds this money. The money is forfeited if the contract is broken.[27] For more perishable commodities other arrangements are developing. A fruit canning company described a market in which sellers pitch tents and post prices in a specific location as the fruit is harvested. Buyers, like himself, come with trucks in search of the best prices for good quality fruit.[28]

An unintended side effect of the restitution program in agriculture is the sharp reduction in the number of milk cows. Milk processors now have great difficulty in obtaining milk. Most plants are operating well below capacity because sufficient supplies are not available locally. Firms' responses to this problem were varied. At one firm the manager considered the milk prices he paid very high and could only justify them because of special yogurts that the firm produced. At another firm, commission agents were paid to obtain milk for the plant. The

[27] One large active trader stated that he would not break the contract even if the price moved more than 3% because his reputation is on the line.

Prices on the exchange are denominated in points which are the equivalent of dollars. (It is illegal to use dollars.) The high and unstable rate of price increases in lev, and the unstable international value of the lev, make "points" more stable than lev.

[28] Rather than make purchases directly itself, sometimes the firm employs agents to do the purchasing for it. There is an incentive contract with the agent where the agent bears some of the cost of low quality purchases.

agents' commissions were comparable to the salary earned by the director.

TABLE 3

Foreign Trade Activity

Do you purchase supplies directly from outside of Bulgaria?

yes	9
small or none	25
none	5
[None is a subset of small or none.]	
N = 35	

Do you sell directly to foreign customers?

yes	12
no	12
nothing at all	8
N = 32	

Identifying trading partners is made more difficult because of the importance of foreign trade in a small country like Bulgaria. Even relatively small firms engage in foreign trade; see Table 3. In the past, most trade was carried out through foreign trading companies. These trading companies still exist (although they have lost their former monopoly power) and many state enterprises still employ them. There are also many new private trading companies which perform similar services. Three state companies in our sample which performed foreign broker services are clearly now experiencing intense competition. In some cases, former employees are taking their knowledge and contacts with them to set up new companies which compete directly with the existing state firm. Sometimes a Bulgarian firm has had a long-term relationship with a foreign company. These Bulgarian firms are now finding that it is possible, in some instances, to bypass the brokerage firm and deal directly with the foreign company.

The Bulgarian press reports that private firms do not wish to trade with state firms and that enterprises searching for trading partners treat foreign firms differently from domestic firms. One of our strongest findings, shown in Table 4, is that these differences do not matter to firms. Even though the response, "it does not matter," did not appear explicitly on the survey form, this was by far the most common response. Firms want customers who pay and suppliers that are reliable. Problems arose with all types of trading partners. Several interviewees gave examples of problems with foreign firms where they did not receive payment. One firm is chasing an American "phantom" in California. State and private firms can be both reliable and unreliable partners. The one distinction that interviewees consistently pointed to was that state budgetary units (i.e. schools, hospitals, military bases, etc) do not pay.[29]

[29] This creates a dilemma- Several interviewees said that they felt an obligation to deliver supplies to these units in spite of their failure to pay because these units provide such essential benefits to society. On the other hand, one firm said that he simply cut off deliveries and was eventually paid.

An important distinction arose here between state enterprises and private firms. Private firms could go bankrupt if they are not paid by a school or hospital; state enterprises and cooperatives seemed to feel that it was a community obligation to support units providing these essential services.

Also, it appears that state budgetary units often do not have any money and so cannot pay, due to the failure of Parliament or a ministry to act, so it was not the unit's fauit. People noted that sometimes the workers at these units are not paid, and the hospitals have no medicines. These units do sometimes receive their allotted budget late, and make partial payments then.

TABLE 4

Preferences for Trading Partners

Prefer to work with Bulgarian firms........................	3
Prefer to work with foreign firms..........................	1
Does not matter whether firm is Bulgarian or foreign	19
N = 22	
Prefer to work with state-owned firms...........,.......	1
Prefer to work with private firms..........................	2
Does not matter whether firm is state-owned or private.....	19
N = 22	

Difficult as it may be in the present climate, Bulgarian firms are expanding their set of customers and suppliers. Almost all firms relate an experience where they have been burned by an unreliable trading partner. They arc now proceeding cautiously. As firms develop new market arrangements and economic agents become more familiar with the workings of the market, this should become easier in the future. For example, Dun and Bradstreet now has an office in Sofia which can provide information on potential partners in Bulgaria and abroad. Firms often appear to be members of informal groups, which share information on business partners. The economic difficulties firms face give strong incentives to seek out new markets, but the process is slow because most people have limited experience in a market economy.

2) Bargaining

Before conducting the survey, we thought that rather than seeing exchange as a process with mutual benefits, Bulgarians viewed trade as an opportunity to exploit a situation to its fullest and then walk away. In contrast, the firms we interviewed understood that if the relationship was going to be long-term both parties had to benefit?'

Relative market power can also affect the bargaining process. The firms interviewed answered overwhelmingly that bargaining took place in an environment where there was equal bargaining power between the parties. See Table 5.

It is hard to judge whether the responses reflected firms that really considered bargaining power to be equal, or whether the firm actually had a more powerful position and therefore less to complain about. These responses can be compared with the responses in Tshle 5 on the competitiveness of the markets for inputs and outputs. Output markets appear to be more competitive than input markets and bargaining power appears to be more equal in output markets.

[30] Our sample may be biased here. Almost all the firms we interviewed have been in business for more than two years. Phantom firms, whose behavior might be closer to our original perceptions, would be harder to locate for an interview. We still believe that our results suggest that there is a better understanding of these issues today than there was earlier in the transition.

TABLE 5

Bargaining Power and Competitiveness of Markets

With Suppliers:

Do your relations with suppliers reflect equal bargaining power between parties?

yes..	22
no.....	9
N = 29	

Could you easily change your supplier?

yes ....**..	16
no, because we are bound by a long-term agreement...	5
no, because we are bound by common assets (real estate property, equipment, equity,etc.)........	1
no, because this might provoke retaliation harmful to my business	2
no, there are no other good suppliers...., ...	6
other	4
N = 27	

With customers:

Do your relations with the customers reflect equal bargaining power between parties?

yes..*	2 1
no...	3
N = 24	

Could you easily change one of your major customers?

yes..	17
no, because we are bound by a long-term agreement..	3
no, because we are bound by common assets (real estate property, equipment, equity,etc.)	0
no, because this might provoke retaliation harmful to my business	1
other, please specify . . . . .I................ (e.g., one has to export)	6
N = 23	

Some state enterprises we interviewed, especially food processors, clearly had more market power than their suppliers, particularly farmers. Often this was due to the dominant regional position they enjoyed. Under central planning they were often the only producer and their inputs came from many farmers. While we could not judge how much control they had over the price, the contractual terms of purchase suggested they were using their market power. Often firms with superior bargaining power can use this power to impose contractual terms. These firms would only make payment after they had time to inspect the quality of the supplies. Payment is based on their evaluation of the quality.[31] However, we encountered one case where similar terms were enforced by a milk processor in spite of the widespread decline in milk production. Thus an alternative explanation is that these large food processors are the more efficient evaluators of quality. (This would be the equilibrium economic explanation, not "bargaining power.") Still, this does not explain why the large firms delay payment to cash-c&strained small firms.

In their business relations with West European companies, Bulgarian firms appear to be at a substantial disadvantage. Several interviewees described situations where they were paid for their goods only after the West European partner had inspected the goods. In contrast, the Bulgarian firm had to pay for foreign supplies in advance or on delivery. A few firms which had trade relations with a foreign firm for some time were very proud of the fact that they could now obtain trade credit from their partner.

[31] For example, one firm stated that it buys between 90-95% of the output of the local market. After studying the quality, it makes payment 30 days later. (Given high monthly interest rates this is a considerable discount.) When asked if there were ever disputes about the quality determination, the manager described a process where the supplier was brought in and given a scientific demonstration how the quality level was determined.

3) Non-Legal Means to Enforce Agreements

From the literature on contract enforcement and the primitive development of the commercial court system in Bulgaria, it was our expectation that little reliance would be placed on the courts. In most business communities norms develop which allow business to go forward. The difficulty in Bulgaria is that there is so little experience with market relations. We look first at the supply side where poor quality would constitute nonfulfillment of the contract and then at the customer side where the concern is failure to pay.

a) Quality of Goods and Services

Macaulay (1963) described an important U.S. business norm as "...One ought to produce a good product and stand behind it." In Bulgaria the transition from low quality goods produced under central planning to high quality goods produced in the market is far from complete, but there is a growing sense of obligation to stand behind what you sell. The expectations of the buyer regarding quality vary widely. Interviewees consistently said that, if there was a complaint about quality, the seller would replace the goods. In one interview a buyer described how a supplier had gone far beyond what was required when it was discovered that the inputs were below expected quality standards (replacing the supplies immediately with a larger quantity, for free). Statements that suppliers would replace substandard goods were made by both buyers and sellers.

A difficulty with maintaining quality is that the quality expectations of buyers is often very low and in many instances quality controls are very poor. In several interviews buyers were frustrated with the low quality of inputs, but they did not see it as a violation of a contract. One food processor had done calculations to show how much money could he saved if the quality of forage were higher. He offered his main supplier a higher price for improved quality but could not get the supplier to put quality standards into the contract. Another frustrated milk processor attributed the Iow quality of milk to the restructuring of agriculture. Inexperienced farmers, new to milk production, could not keep bacteria levels down.[32] In fact, the farmers made no effort to reduce bacteria levels, despite urging, free equipment, and instruction by the milk processor.

A private trading company involved in Western Europe related a case where a shipment was rejected by a Western European company. Even though he questioned the honesty of the Western European company, he made good on the shipment. However, when asked whether he inspected goods that were shipped to his warehouses (and then shipped out to commercial customers), he admitted that he did not.

In brief, there does appear to be a norm developing that suppliers have an obligation to stand behind their products when they promise that a standard will be met. On the other hand the expectations of buyers who have experienced the low quality and service standards of the central planning system is very low.[33] The combination of these factors results in relatively few contractual disputes with suppliers (compared to complaints about customers), as show in Table 6.

[32] In the food processing industry, quality has another important dimension. There has been great concern among consumers about the deterioration of food sanitation. The government had controls when all food was processed by state companies, but new administrative units had to be established to protect food supplies now that private firms are involved. During our interviews we heard complaints that inspectors accepted bribes and that the local government in one area was intimidated by mafia-type figures when the municipality tried to enforce sanitation ordinances.

[33] We discussed milk, cheese and yoghurt quality with a number of producers. Two described efforts to sell high-priced “fancy” yoghurt products, but felt that the deep depression in Bulgarian incomes was limiting demand to the cheapest necessities.

TABLE 6

Contractual Disputes

Suppliers:

Do you ever have formal written contracts with your suppiiers?

yes	27
no	L0
(some multiple responses)	
N = 35	

If you have written contracts, have you ever taken legal action against your supplier in case of contract violation?

yes	8
no	14

If you do not have written contracts, have you had problems with your suppliers?

yes	3
no	8
N = 11	

Customers:

Do you ever have contracts with your customers?

yes	23
no	11
N = 31	

If you have written contracts, have you ever had a disagreement with a customer about fulfillment of a contract?

yes	16
no	4
N = 20	

If you do not have a written contract, have you ever taken legal action against a customer?

yes	11
no	9
N = 20	

b) Payment Practices

At this point in the development of the Bulgarian market system, most sellers carefully protect themselves against future non-payment. The easiest way to manage this is to insist on payment either before the transaction is completed or at the time that the transaction occurs. Where pre-payment or coincidental payment does not occur, payment is often by bank transfer. The major exceptions to this rule occurs when 1) a long-term relationship has been established, 2) the Bulgarian firm is anxious to sell to a foreign (usually West European) customer or 3) a state firm or cooperative feels a social obligation to sell to a hospital, school or other social agency. See Table 7.

TABLE 7

Payment Guidelines

When you sell your product to a customer, do you typically require that these enterprises pay you:

before you ship the goods	15
when they receive the goods	23
within a specified time after receiving the goods......	15
within an unspecified time after receiving the goods..	0
N= 32	

Conditions under which delayed payments were **permitted:**

Only with most reliable customers..	5
Only with specific customers..	4
With state budgetary units.............................	1
Foreign customers	1
No special group identified...........................	3
N= 14	

If the only products being produced in an economy were standardized products which could be sold on spot markets, this would represent a great weakness in the economy. There are important economies of scale from producing customized or semi-customized goods. If contracts could only be written for standardized goods, these economies would be lost. Most of the firms we interviewed produced standardized products, but a few produced a semi-customized product that is modified for individual customers. These latter firms generally received prepayment that approximately covered their costs during the early development of the product. For example, we interviewed a private firm which produces semi-customized filling equipment for which there is high demand. The firm was paid 40% within five days of signing a contract, 40% at inspection of the equipment two days before delivery, and 20% after the equipment is up and running. They return ten days after the machine is in operation to help with any problems. This firm stressed that quality was very important to them as was their overall reputation. They offer a one-year warranty and repair contract. The firm's interests are protected since the scheme reflects the risks they run in building a semi-customized product. The buyer, on the other hand, is running a greater risk of losing their money if the equipment is not delivered. A case occurred in which two machines were ordered, but only one was actually purchased. The buyer lost the 40% down payment.

Another form of contract enforcement is the use of mafia tactics. While we did not ask any direct questions about mafia activities, several interviewees referred to such activities and admitted to using enforcers when necessary. Some firms have found it necessary to hire enforcers to protect themselves from others. One firm suggested that it was not safe to sell its product domestically (rather, it exported the product to a neighboring country). Another private firm was concerned about responding to financial questions for fear that the information would be disseminated. One firm, which admitted to using enforcers, made it clear that enforcers were used in the private sector but not in the state sector.

4) Enforcement through Legal Channels

From our reading of Macauley (1963) and Ellickson (1991), we expected that there would be little litigation. We found the opposite to be the case. Many firms we interviewed had gone to court or contemplated going to court. (See Table 8). Indeed, the courts are crowded with commercial cases and backlogs are long. Several firms were also suing in foreign courts, although success there appeared to be very limited.

There was a consensus among our interviewees, including some who were suing trading partners, that court action was unlikely to bring redress. Several managers said that they did not bother with the courts because they did not expect to be compensated. Since this is the general attitude, it is clear that managers do not depend on lawyers and courts to enforce their contracts. It is also interesting that no one mentioned going to the police to propose criminal fraud cases against "phantom" firms.

In spite of crowded court dockets, several firms were successful in court. The manager of one firm that won a court case still complained that it took four months from filing suit before he was paid. Another firm we spoke with expected to receive a chicken farm as compensation in the near future.[34] Still another firm had a considerable collection of farm equipment seized by court order from debtors who had not paid. Although our sample is not large enough to verify this, there appears to be gap between the low subjective probability which managers place on being compensated through court action and the actual facts.

In addition to the regular courts, the Bulgarian Chamber of Commerce provides private

---

[34] The chicken farm was bankrupt. The firm does not really want a chicken farm. It cannot sell the farm, however, since the farm is state property. The firm plans to take out a bank loan using the farm as collateral and then default on the loan. The firm obtains money this way, although less than they would like. Under the law, the bank is allowed to sell the farm.

arbitration procedures. Thus far, arbitration has been used mostly in settling disputes involving foreign firms, but it is also available for settling disputes between Bulgarian firms. Judgments still have to be enforced by the courts (should firms refuse to abide by the arbitration decision), but arbitration decisions can be made much more quickly since the arbitrations courts, in contrast to the backlogged legal courts, are little used.[35]

Given the low probability managers attach to success it is surprising that there is so much court action. One explanation is that some state firms feel an obligation to sue as a signal to superiors that they have done everything possible to resolve a dispute. Table 8 shows that state firms do go to court more often than private firms.

TABLE 8

Who Goes to Court

		State	Private	Cooperatives
Have Lawsuits Against Suppliers?				
	Yes	3	2	0
	No	6	3	4
N = 22				
Have Lawsuits Against Customers?				
	Yes	9	1	0
	No	2	5	1
N = 15				
Totals				
	Yes	12	3	0
	No	8	8	5

[35] Mark S. Beesley and Stephan Kyutchukov from the American Bar Association's Central and Eastern European Civil Education Project provided us with important information on the functioning of the court and arbitration systems.

Another possible explanation for the large number of suits is that, while the rewards from going to court are small, the cost of going to court is also low. Macauley (1963) and Ellickson (1991) see a very high cost in going to court. For Macauiey, court action generally means the end of an important business relationship. For Ellickson, many of the disputes he describes are between neighbors who have to live near one another in the future. In the fluid situation which presently exists in Bulgaria, cutting off a customer who refuses to pay may be perceived as having a low cost, especially if the other firm is suspected of being a "phantom" firm. In contrast, one large manufacturing firm we interviewed described a situation where they were agonizing over a decision to sue an important foreign customer. They understood that this would mean the end of an important relationship, but they were beginning to conclude that court action was the only way they might receive payment.[36]

VII. Further Research and Conclusion

Our research to this point has developed a number of results, but there are some additional points that might be developed further with the data available. Here are some points we plan to examine further. (1) How strong is the law and enforcement on the prevention of fraud in Bulgaria? Specifically, is there a law against the sort of fraud ("phantom firms" and refusal to pay) we observed? Do prosecutors enforce laws against fraud? (2) How severe was the harm from the breakup of firms, particularly those previously connccted with food processing? This is an area with particularly severe contractual problems. If the breakups were entirely arbitrary, Mancur Olson's principle that losses due to deviations from competitive equilibrium should be

[36] We have not yet tested whether controlling for size of firm and length of time in business will affect this relationship.

small, should not hold. (3) Distinguish between equilibrium and out-of-equilibrium behavior. Many of the early contracts that led to lawsuits were "mistakes," we were informed; can they be distinguished from current behavior? (4) Develop in more detail the underlying theory of incomplete contracts in a transition economy. Is Williamson's "mutual hostage" situation, where firms face large individual deals from which each could renege, an important factor in causing contractual failure? (5) While state enterprise firms were more likely to sue than other firms, is that the result of other factors? Consider size of firms, age, and industry as additional factors in a regression analysis.

Three and a half years after the "big bang" in Bulgaria, we found that business firms faced a great deal of flux and change. Business people were seeking new partners with which to trade, and redefining old relationships. New market arrangements are developing and these are making it easier for market trades to take place. A great deal of learning by doing has occurred in a relatively short period of time.

The large number of lawsuits is one indication of the fluidity of the present situation. 'The rules of the game are still evolving. The last question in our survey was designed to elicit general impressions about the present business climate. The results suggest that the evolution of stable property rights still has a considerable distance to go. We asked people whether the following statement applied to Bulgaria today: "The world is a jungle in which only the strongest survive." The answers revealed a variety of views about present conditions.

At one end of the spectrum were responses that reflect commonly held beliefs about the business community: "Globally speaking - yes [it is a jungle]. Those who work honestly cannot prosper." A more common response, however, was more in keeping with the notion that successful business people will be those who take a longer-run view: "The honest people and those who have long-run horizons will survive." Still, most managers saw business as a rough and tumble world full of uncertainty. As one put it: "I prefer to be a wolf with good character." Several managers saw the present period as a temporary and unfortunate period; a period of capital accumulation, not untike the U.S. "robber baron" experience at the end of the 19th century. When this period ends, they are looking forward to a better future. As one manager expressed it: "The cultivation of the jungle has begun and it will be turned into a garden."

Bibliography

Baer, Herbert and Cheryl Gray, ""Debt as a Control Device in Transitional Economies: The Experiences of Hungary and Poland," Presented at Joint Conference of the World Bank and the Central European University Privatization Project, Corporate Governance in Central Europe and Russia, December 1994.

Banfield, Edward C., The Moral Basis of a Backward Society, New York: Free Press, 1958.

Barthody. Kasper. "Statistical Review". Economics of Transition, 2:11 l-27, No. 1, March 1994.

Calvo, Guillermo A. and Fabrizio Coricelli, "Output Collapse in Eastern Europe: The Role of Credit," in eds. Mario Blejar, Guillermo A. Calvo, Fabrizio Coricelli, and Alan Gelb, Eastern Europe in Transition: From Recession to Growth?: Proceeding of a Conference on the Macroeconomic Aspects of Adjustment, World Bank Discussion Paper #196, 1993.

Casson, Mark, The Economics of Business Culture: Game Theory, Transaction Costs, and Economic Performance, Oxford: Oxford University Press, 1991.

Clague, Christopher, "Relative Efficiency, Self-Containment, and Comparative Costs of Less Developed Countries," Economic Development and Cultural Change, 39:507-530, April 1991.

Clague, Christopher, "Rule Obedience, Organizational Loyalty and Economic Development," Journal of Institutional and Theoretical Economics, 149:393-414, June 1993.

Craswell, Richard, "On the Uses of 'Trust': Comment on Williamson, 'Calculativeness, Trust and Economic Organization,"' Journal of Law and Economics, pp. 487-500, Vol. 36, (April 1993)

Dasgupta, Partha, "Trust as a Commodity" in Diego Gambetta, (ed) Trust: Making and Breaking Cooperative Relations, Oxford: Basil Blackwell, 1988.

De Melo, Martha and Gur Ofer, "Private Service Firms in a Transitional Economy: Findings of a Survey in St. Petersburg," World Bank Studies of Economies in Transformation #11, 1994.

Devereaux, Stephen and John Hoddinott, Fieldwork in Developing Countries, Boulder, Colorado: Lynne Rienner Publishers, 1993.

Dobrinsky, Rumen, "Enterprise Arrears and Bad Loans in Bulgaria," (Working paper XXI Century Foundation - Centre for Strategic Business and Political Studies, Sofia, Bulgaria, August 1994).

Ellickson, Robert C., Order Without Law: How Neighbors Settle Disputes, Cambridge, Mass. Harvard University Press, 1991.

Freeman, Scott, "Underdevelopment and the Enforcement of Laws and Contracts," Federal Reserve Bank of Dallas Research Paper 9 110, July 1991.

Frydman, Roman et.al., "Eastern European Experience with Small-Scale Privatization," CFS Discussion Paper #104, World Bank, April 1994.

Fudenberg, Drew, Bengt Holmstrom and Paul Milgrom, "Short-term Contracts and Long-term Agency Relationships, Journal of Economic Theory June 1990.

Gambetta, Diego, (ed) Trust: Making and Breaking Cooperative Relations, Oxford: Basil Blackwell, 1988.

Greif, Avner and Eugene Kandel, "Contract Enforcement Institutions: Historical Perspective and Current Status in Russia," in Edward Lazear, ed., Economic Transition in Eastern Europe and Russia: Realities of Reform, Hoover Institution Press, 1995.

Greif, Avner, Paul Milgrom and Barry R. Weingast, "Coordination, Commitment, and Enforcement: The Case of the Merchant Guild," Journal of Political Economy 102:745-776, August 1994.

Grey, Cheryl W. "Evolving Legal Frameworks for Private Sector Development in Central and Eastern Europe," World Bank Discussion Papers, No. 209, 1993.

Hackett, Steven C., "Is Relational Exchange Possible in the Absence of Reputations and Repeated Contact?" Journal of Law, Economics and Organization 10:360-389, 1994.

Klein, Benjamin, Robert G. Crawford, and Armen A. Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," Journal of Law and Economics, 21:297-326, October 1978.

Lamoreaux, Naomi R., "Information Problems and Banks' Specialization in Short-Term Commercial Lending: New England in the Nineteenth Century," in Peter Temin, ed., Inside the Business Enterprise: Historical Perspectives on the Use of Information, Chicago: University of Chicago Press, 1991.

Lamoreaux, Naomi R., Insider Lending: Banks, Personal Connections, and Economic Development in Industrial New England, New York: Cambridge University Press, 1994.

Landa, Janet T., Trust, Ethnicitv and Identitv: Beyond the New Institutional Economics of Ethnic Trading Networks. Connact Law, and Gift-Changing, Ann Arbor: University of Michigan Press, 1994.

Macaulay, Stuart "Non-contractual Relations in Business: A Preliminary Study," American Sociological Review 28:55-67, February 1963.

Murrell, Peter, "Evolution in Economics and in the Economic Reform of the Centrally Planned Economies," in Christopher Clague and Gordon C. Rausser, eds., The Emergence of Market Economics in Eastern Europe, Cambridge, Mass.: Blackwell. 1992.

North, Douglass C., Institutions, Institutional Change and Economic Performance, New York: Cambridge University Press, 1990.

Paley, Thomas, "Comparative Institutional Economics: The Governance of Rail Freight Contracting," Journal of Legal Studies 13: 265-87, June 1984.

Rubin, Paul H., "Growing a Legal System, with Special Reference to the Post-Communist Economies," IRIS Working Paper No. 63, June 1993. Cornell International Law Journal, 27, Winter 1994.

Sako, Mari, prices, Quality, and Trust: Inter-Firm Relations in Britain and Japan, New York: Cambridge University Press, 1992.

Smith, J.K. and C. Schnucker, "An Empirical Examination of Organizational Structure: The Economics of the Factoring Decision," Journal of Cornorate Finance 1: 119-138, March 1994.

Transition, "Oxford Analytica Reports on Red Conglomerates in Bulgaria," 6:5, March 1995.

Tourevski, Mark and Eileen Morgan, Cutting the Red Tape: How Western Companies Can Profit in the New Russia New York: Free Press, 1993.

Wall Street Journal, "Bust-Out Swindles Appear to Be Busting Out All Over," John R. Emshwiller, April 26, 1995, p. B2.

Webster, Leila M. and Joshua Charap, "The Emergence of Private Sector Manufacturing in St. Petersburg: A Survey of Firms," World Bank Technical Paper #228, 1993.

Webster, Leila M. and Dan Swanson, "The Emergence of Private Sector Manufacturing in the Former Czech and Slovak Fcderal Rcpublic," World Bank Technical Paper #230, 1993.

Wiggins, Steven N., "Ownership as a Commitment Device, Incomplete Contracting, and Innovation," Texas A&M Working Paper 90-21, February 1990.

Williamson, Oliver, Markets and Hierarchies: Analysis and Antitrust Implications. New York: Frcc Press, 1975.

Williamson, Oliver, The Economic Institutions of Capitalism. New York: Free Press, 1985.

Williamson, Oliver, "Institutions and Economic Organization: The Governance Perspective" Annual Bank Conference on Development Economics, World Bank, April 28-29, 1994,

World Bank, Bulgaria: An Economic Update Report prepared for the Meetings of the G-24 and World Bank Consultative Group' May 12-13, 1993